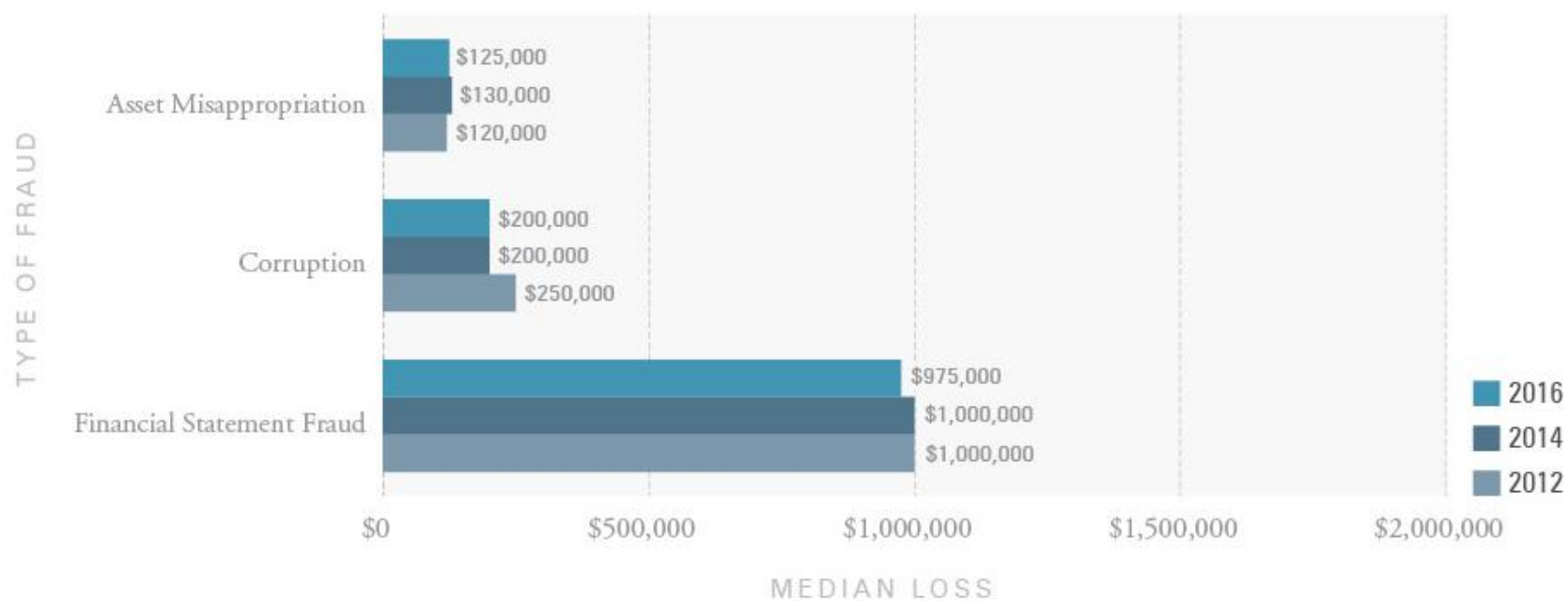


# 2016 Fraud Seminar

## *Financial Statement Fraud*

# How Fraud Is Committed

**Figure 5:** Occupational Frauds by Category—Median Loss



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# Financial Statement Fraud—Intro

This presentation will cover a variety of financial statement frauds and include:

- § Red flags to watch out for
- § Techniques to uncover the fraud

Please share your stories throughout

- § What have you seen in these areas?
- § Does anyone have examples?

# Financial Statement Fraud

- § Often a means to an end, rather than an end in itself
  - Conceal deteriorating financial performance
  - Improved results for pending deals
- § Unlike other forms of fraud, perpetrators may gain little or nothing in personal financial terms

# Financial Statement Fraud



# Financial Statement Fraud Definition

- § The *deliberate misrepresentation*
- § Of the entity's financial condition
- § Accomplished through the intentional *misstatement or omission* of amounts or disclosures in the financial statements
- § To *deceive* financial statement readers and users

# What Makes It Fraud?

- § Violation of accounting principles
- § Intent



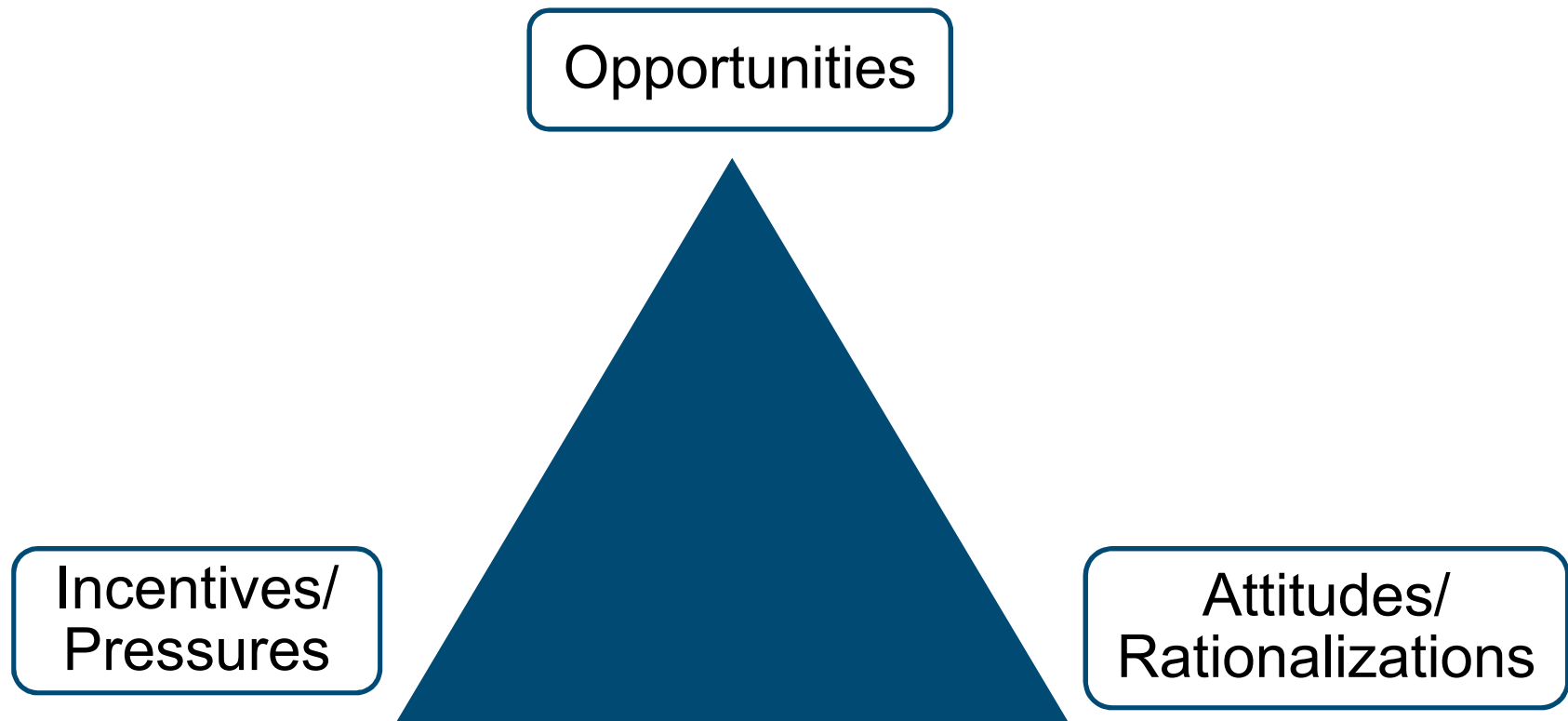
# What Makes It Fraud?





# Group Activity:

## What are the red flags of an environment conducive to financial statement fraud?



# Opportunities

- § Significant related party transactions not in ordinary course of business
- § Estimates involving significant judgment
- § Significant, unusual or complex transactions
- § Ineffective monitoring of management or others by TCWG
- § Overly complex organization structure
- § Inadequate monitoring of controls

# Incentives/pressures

- § High degree of competition
- § Declines in customer demand
- § Pressure to meet analyst, investor or creditor expectations
- § Compensation tied to company performance
- § Personal guarantees of debt
- § Personal financial obligations create pressures on employees

# Rationalizations

- Ineffective communication, support or enforcement of values & ethics
- History of violations of laws/ regulations
- Attempts to justify marginal or inappropriate accounting
- Poor relationship with auditors
- Not correcting material weaknesses or significant deficiencies timely
- An interest by the owner to minimize or maximize earnings

# What are some of the challenges in identifying an environment conducive to financial statement fraud?



## Debrief: Challenges

- § Time, fee, budget pressure
- § Want to assume positive intent
- § Don't look past prior year to identify unusual patterns
- § Encounter very few financial reporting frauds
- § Judgment biases
- § Materiality constraints
- § Reluctance to involve others
- § Reluctance to expand procedures/scope
- § SALY
- § Afraid to ask too many questions
- § Lack of experience
- § Auditing through email

# Improper Revenue Recognition

- § Professional standards presume that revenue recognition is a fraud risk.
- It's usually the largest amount in the financial statements
  - It's where the most financial reporting frauds occur

# Red Flags of Improper Revenue Recognition

- § Unusual increase in gross margin or gross margin in excess of industry peers
- § Unusual growth in the number of days' sales in A/R
- § A significant volume of sales to entities whose substance and ownership is unknown
- § Significant transactions with related parties or special-purpose entities not in the ordinary course of business, or where those entities are unaudited or are audited by another firm



# Red Flags of Improper Revenue Recognition

- § An unusual surge in sales by a minority of units within a company, or of sales recorded by corporate headquarters
- § Significant, unusual, or highly complex transactions, especially those close to period-end that pose difficult “substance over form” questions
- § Unusual decline in number of days’ purchases in A/P

# Red Flags of Improper Revenue Recognition

- § Unexplained or unusual changes in accounting policies or accounting estimates in connection with revenue recognition
- § Changes in auditors or other signs of disagreements with auditors over revenue recognition issues

# Techniques to Uncover Revenue Recognition Schemes

- § Vouch transactions.
- § Review subsequent-period transactions.
- § Perform a cut-off test.
- § Examine supporting documents.
- § Identify anomalies in accounting records.

# Improper Deferral of Costs and Expenses

## § Capitalizing expenditures

- Advertising and marketing
- Software
- Start-up costs
- Interest
- Repairs and maintenance
- Costs associated with intangibles

## § Changing accounting policies

## § Improper amortization

## § Improper accounting for business combinations

## § Improper accounting for reducing asset reserves

# WORLD COM SCANDAL (2002)

COMPANY



Telecommunications company; now MCI, Inc.

## WHAT HAPPENED

Inflated assets by as much as **\$11 billion**, leading to 30,000 lost jobs and \$180 billion in losses for investors.



## MAIN PLAYER

CEO Bernie Ebbers

## HOW HE DID IT

Underreported line costs by capitalizing rather than expensing, and inflated revenues with fake accounting entries.



## HOW HE GOT CAUGHT

WorldCom's internal auditing department uncovered **\$3.8 billion** in fraud.



## PENALTIES

CFO was fired, controller resigned, and the company filed for bankruptcy. Ebbers **sentenced to 25 years for fraud**, conspiracy and filing false documents with regulators.



## FUN FACT

Following the scandal, Congress passed the Sarbanes-Oxley Act, introducing the most sweeping set of new business regulations since the 1930s.



# Red Flags of Improper Deferral of Costs and Expenses

- § Reducing accounts payable while competitors are stretching out payments to vendors
- § Unusual increase in gross margin or margin in excess of industry peers
- § Allowances for sales returns, warranty claims, etc. that are shrinking in percentage terms or otherwise out of line with industry peers
- § Unusual reduction in the number of days' purchases in accounts payable ratio

# Techniques to Uncover Improper Deferral of Costs and Expenses

- § Scrutinize documentation supporting amounts capitalized as intangible assets.
- § Analyze amortization of intangibles with finite lives.
- § Analyze intangible assets for evidence of impairment.
- § Inspect evidence to support reserves recorded at acquisition.

# Improper Asset Valuation—Inventory

Generally, inventory is manipulated by:

- Overstating physical counts
- Increasing inventory valuation amount

***What techniques can be used to artificially inflate inventory?***

**In table groups - take 3 minutes**





# Red Flags of Improper Inventory Valuation

- § Unusual increase in gross margin or margin in excess of industry peers
- § Unusual growth in the number of days' purchases in inventory
- § Percent of excess/obsolete inventory shrinking or out of line with industry peers
- § Significant upward inventory adjustments at locations that were not observed by the auditors compared to locations that were observed
- § All or part of inventory pledged as security for loans

# Techniques to Uncover Improper Inventory Valuation

- § Trace inventory items back to independent test counts or notation of test counts.
- § Perform expanded cut-off tests.
- § Review subsequent period journal entries.
- § Confirm purchases with suppliers.
- § Perform analytical comparisons.
- § Compare products affected by changes in technology or markets with recent and subsequent period sales activity.
- § Perform detailed pricing tests; ask management to justify any questionable determinations that could have a significant effect.

# Improper Asset Valuation— Accounts Receivable

§ Generally, accounts receivable is manipulated by:

- Creating fictitious accounts receivable
- Manipulating auditor confirmation procedures
- Failing to properly account for uncollectible accounts

# Red Flags of Accounts Receivable Fraud

- § Unusual increase in gross margin or margin in excess of industry peers
- § Unusual growth in the number of days' sales in receivables
- § Allowances for bad debts that are shrinking or are out of line with industry peers
- § Entries in the G/L not made in the subsidiary ledger of customer accounts
- § Large or unusual returns or allowances during the month immediately after the FS date

# Techniques to Uncover Accounts Receivable Fraud

- § Look for entries in GL account that were not detailed in the A/R subsidiary ledger
- § Examine authenticity of:
  - Large or unusual sales made during the three weeks preceding the balance sheet date
  - Large or unusual items included in accounts receivable
  - Large or unusual sales returns/allowances during the month immediately following the balance sheet date
  - Any A/R from affiliates
  - Any unbilled A/R included in receivables

# Techniques to Uncover Accounts Receivable Fraud

## § Determine whether:

- Disputes by customers over the correctness of amounts owed are handled by someone outside A/R
- The total of the customers' accounts in the A/R subsidiary ledger are regularly balanced with the GL control account
- Confirmations of customer accounts are processed by someone outside A/R
- The internal audit department periodically, and on a surprise basis, sends account confirmations to customers

# Improper Asset Valuation—Fixed Assets

- § Fictitious fixed assets
- § Misrepresenting fixed asset costs
- § Capitalizing unrelated costs of fixed assets
- § Understating fixed assets

# Red Flags of Fixed Asset Fraud

- § Unusual change in the relationship between fixed assets and depreciation
- § Adding to assets while competitors are reducing capital tied up in assets
- § Increasing fixed assets that do not result in increased sales, capacity, or efficiencies
- § Abandoned or unused fixed assets included in the fixed asset accounts
- § Unsupported basis for allocation of fixed assets in a merger



# Techniques to Uncover Fixed Asset Fraud

- § Scrutinize additions to property and equipment.
- § Compare capitalized costs for the period to authorized expenditures or capital budgets.
- § Inspect records for miscellaneous cash receipts and other income for evidence of proceeds from fixed asset dispositions.

# Improper Recording of Liabilities

- § Liability omissions
- § Improper write-off of reserves
- § Unrecorded or undisclosed warranties
- § Change in accounting assumptions
- § Recording excess reserves

## Red Flags of Improper Recording of Liabilities

- § Unusual increase in gross margin or margin in excess of industry peers
- § Allowances for sales returns and warranty claims shrinking in percentage terms or otherwise out of line with industry peers
- § Unusual reduction in the number of days' purchases in A/P
- § Reduction in payables while competitors are stretching out payments to vendors

# Techniques to Uncover Improper Recording of Liabilities

- § Perform a search for unrecorded liabilities.
- § Calculate the number of days in A/P, and compare it to prior periods and benchmarks.
- § Analyze changes in gross profit.
- § Analyze historical trends in accruals and related expense accounts.
- § Confirm loan balances and terms with lenders.
- § Recompute maturities of long-term debt.
- § Analyze terms of equity arrangements, and compare them to current accounting treatment.

# Inadequate Disclosures

- § Liability-related omissions
- § Subsequent events
- § Related-party transactions
- § Accounting changes

# Red Flags of Inadequate Disclosures

- § Significant, unusual, or highly complex transactions, especially those close to period-end that pose difficult “substance over form” questions
- § Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
- § Significant bank accounts or subsidiary/branch operations in tax-haven jurisdictions with no clear business justification

# Red Flags of Inadequate Disclosures

- § Overly complex organizational structure
- § Known history of legal/regulatory violations or claims against the entity, senior management, or board members
- § Recurring attempts by management to justify marginal or inappropriate accounting
- § Restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee

# Financial Statement Fraud





# Financial Statement Fraud—Wrap Up

Discuss key takeaways:

- § What did you learn?
- § What will be most useful?
- § How can you apply what you've learned to your audits?